Docket No. 02-0864
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SURREBUTTAL TESTIMONY

of

MICHAEL McNALLY

FINANCE DEPARTMENT

FINANCIAL ANALYSIS DIVISION

ILLINOIS COMMERCE COMMISSION

ILLINOIS BELL TELEPHONE COMPANY

FILING TO INCREASE UNBUNDLED LOOP AND NONRECURRING RATES

Docket No. 02-0864

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WITNESS IDENTIFICATION

Q. Please state your name and business address.

A. My name is Michael McNally. My business address is 527 East Capitol Avenue, Springfield, IL 62701.

Q. Are you the same Michael McNally who testified previously in this proceeding?

A. Yes, I am.

Q. Please state the purpose of your testimony in this proceeding.

A. The purpose of my testimony is to respond to the rebuttal testimony of AT&T Communications of Illinois, Inc. and WorldCom, Inc. ("AT&T") witness Terry L. Murray (AT&T/MCI Joint Ex. 3). I will also present my corrected calculation of the EBITDA interest coverage ratio, which I described in my direct testimony.

RESPONSE TO MS. MURRAY

Q. Please evaluate Ms. Murray's rebuttal testimony.

A. Ms. Murray argues that my analysis is flawed because: 1) my use of a constant growth discounted cash flow ("DCF") model is inappropriate, 2) my Telecom Sample is riskier than SBC, and 3) my capital asset pricing model ("CAPM") analysis contains an excessive equity risk premium.[1] However, Ms. Murray's rebuttal testimony contains nothing to change my opinion of the overall cost of

[1] AT&T/MCI Joint Ex. 3 at 3-6.

capital for SBC Illinois's unbundled network element ("UNE") loops. In my judgment, the overall cost of capital for SBC Illinois' UNE loops equals 8.62%.

Constant Growth DCF

Q. Ms. Murray indicates that a constant growth DCF model cannot produce an accurate forward-looking cost of equity if the assumed constant growth rate differs from the growth rate of the economy as a whole.[2] Is she correct?

A. Ms. Murray is partially correct. Mathematically, if the growth rate used to determine an individual company's terminal value exceeds that of the overall economy in perpetuity, that company will eventually overtake the entire economy. I do not expect that to occur. However, the growth of an individual company can certainly exceed that of the overall economy over a finite period. Conversely, there is no reason that a company cannot grow more slowly than the economy as a whole in perpetuity.

Q. Given your response to the previous question, is it still appropriate to use a constant growth DCF model in this proceeding?

A. Yes. The concept underlying DCF analysis is to project all future cash flows for a company and discount those cash flows to their present values. In theory, each cash flow could grow at a distinct rate from the prior cash flow. Thus, to obtain absolute accuracy, an analyst would need to estimate an infinite series of growth rates. To simplify this process, the DCF model employs a limited number of growth rate estimates, each representing the anticipated average growth rate

[2] AT&T/MCI Joint Ex. 3 at 4, 15-16.

over a given period of time. A multi-stage DCF includes one or more stages of abnormal growth along with a terminal growth stage that reflects the target company's average growth rate in perpetuity. A constant growth DCF model is a one-stage DCF model that assumes that the selected growth rate input is a reasonable estimate of the target company's average growth rate in perpetuity. Since the growth rate of an individual company cannot continuously exceed that of the overall economy in perpetuity, to assess the reasonableness of the constant growth assumption one must evaluate the available company-specific growth rates relative to those of the overall economy in perpetuity. Unfortunately, the future growth rate of the overall economy in perpetuity is unknowable. Indeed, to my knowledge, no reputable publication releases an estimate of the growth rate of the overall economy in perpetuity.

However, current long-term growth rate forecasts for the overall economy, which typically span 10 to 20 years, can serve as a rough estimate of the growth rate of the overall economy in perpetuity. Since those growth rate estimates are merely inexact forecasts of growth during the next 10 to 20 years, they certainly represent no more than inexact proxies for growth into perpetuity. Nevertheless, they do provide a general benchmark by which the appropriateness of company-specific growth rates can be gauged. At the time of my analysis, the average growth rate for the companies in my Telecom Sample was 7.09%, while the 10 to 20 year growth rate estimate for the overall economy was approximately 6.0%. As Ms. Murray notes, I contrasted the growth rates from my analysis with those in Staff witness Janis Freetly's in Docket Nos. 98-0252/98-0335 (Consol.).[3] In that proceeding, Ms. Freetly concluded that the use of a non-constant DCF

[3] ICC Staff Exhibit 12.0 at 9.

model was warranted due to the significant difference between the average growth rate for her sample (13.19%) and the long-term growth rate estimate for the overall economy (5.0%). Clearly, the more than 8% difference in growth rates in Ms. Freetly's analysis rendered the constant growth DCF inappropriate at that time. In contrast, the same cannot be said for the approximately 1% difference in growth rates in my analysis, given the inexactitude of long-term growth rate estimates. Moreover, the greater weighting applied to the first five years of cash flow growth in present value analysis makes that difference even less consequential. Thus, a multi-stage DCF analysis is not necessary at this time.

Additionally, Ms. Murray's proposed alternative, a multi-stage DCF model, merely exchanges one set of assumptions for another. That is, to implement a multi-stage DCF model, one must subjectively estimate both the length of the transition period and the magnitude of transition period growth. For example, Ms. Murray's 3-stage DCF model assumes all growth rates will converge to the economy-wide growth rate in 15 years.[4] Ms. Murray has not presented any evidence to support that assumption. If it were clear that current company-specific growth rate estimates represented abnormal growth, as was the case in Docket No. 98-0252/98-0335 (Consol.), a multi-stage DCF model would be warranted, and a judgment with regard to appropriate parameters for the transition period would be necessary. However, given the slight difference between the average growth rate for my Telecom Sample and the growth rate estimate for the overall economy, such a judgment is unnecessary. Thus, a non-constant DCF proposal is not clearly better than a constant growth model at this time.

[4] AT&T/MCI Joint Ex. 2 at 23.

Telecom Sample Risk

Q. Ms. Murray suggests that some of the companies in your Telecom Sample do not provide appropriate measures of the cost of capital for UNEs.[5] Do you agree?

A. No. Ms. Murray claims that my required return recommendation is inflated because my Telecom Sample includes firms that she perceives to be "much" riskier than SBC. She suggests that the three regional Bell operating companies in my Telecom sample provide better comparables. However, the Commission is not setting rates for SBC's overall operations or the overall operations of other ILECs. It is setting rates specifically for UNEs. As I noted in my previous testimony, the FCC directed that UNE loop rates reflect facilities-based competition. In my judgment, my Telecom Sample, which comprises diversified telecommunications companies reflecting a combination of regulated and unregulated operations, is appropriate for setting UNE rates, given the FCC's directives. As explained in my rebuttal testimony, the moderately high degree of competitive risk reflected in my recommendation is consistent with the degree of efficiency reflected in the other cost components of Staff's proposed UNE loop rates.[6]

Equity Risk Premium in CAPM Analysis

Q. Ms. Murray criticizes your use of a current "spot" equity risk premium estimate, cites several lower risk premium estimates, and concludes that

[5] AT&T/MCI Joint Ex. 3 at 5,18-19.
[6] ICC Staff Exhibit 31.0 at 4.

your CAPM overstates the cost of capital due to an excessive equity risk premium.[7] Please comment.

A. Significantly, only the *magnitude* of investors' return requirements is relevant, not the *reasonableness* of those requirements. The equity risk premium embedded in my CAPM analysis is a direct measurement of the current equity risk premium based on current market data. Nevertheless, Ms. Murray opines that the current expected risk premium is too high based on equity risk premium estimates from studies that are based on longer time series of data.[8] However, the use of a time series necessarily introduces historical data, which favors outdated information that the market no longer considers relevant over the most-recently available information. In contrast, current expectations incorporate all relevant available information. As proxies for the current expected equity risk premium, historical expected equity risk premiums suffer several shortcomings. First, the returns an investment generates are unlikely to have equaled investor return requirements due to unpredictable economic, industry-related, or company-specific events. Second, even if an investment's return equaled investor requirements in a given period, both the price of, and the investment's sensitivity to, each source of risk changes over time. Consequently, the past relationship between two investments, such as common equity and debt, is unlikely to remain constant. Finally, because of the dynamic relationship between common equity and debt, the magnitude of the historical risk premium depends upon the measurement period used. Unfortunately, no proven method exists for determining the appropriate measurement period. Thus, historical risk premiums are questionable estimates of the expected risk premium that are susceptible to

[7] AT&T/MCI Joint Ex. 3 at 5, 19-22.
[8] AT&T/MCI Joint Ex. 3 at 21.

manipulation and whose use could distort the estimate of a company's cost of equity. The only equity risk premium that is relevant to investors' current required return is the current equity risk premium, which is reflected in current market data.

Q. Ms. Murray claims that your estimate of the current equity risk premium is flawed because the market return requirement is based on a constant growth DCF.[9] Please comment.

A. As noted previously, one would not expect an individual company to maintain a higher growth rate than that of the overall economy in perpetuity. However, at any given time, certain individual companies will grow faster than the overall economy over a finite period, while others will grow more slowly. Thus, it is not unreasonable to expect an index, such as the S&P500, to maintain a higher growth rate than that of the overall economy, since an index is a dynamic compilation of companies (e.g., if a company's financial viability declines, it may be replaced in the index by a new company with superior prospects). This survivorship bias may produce a higher average growth rate for the index than that of the overall market. However, that does not necessarily render the required return on the S&P 500 a poor proxy for the market return component of the CAPM.[10]

[9] AT&T/MCI Joint Ex. 3 at 5, 19.

[10] Growth is only one of two components of the investor-expected return. The other component is current income (e.g., dividends). For a given investor-expected return, the higher the growth component, the lower the income component, and vice-versa.

CORRECTION TO EBITDA INTEREST COVERAGE TARGET

Q. In your direct testimony you indicated that you would update your analysis to reflect the removal of Sprint from the EBITDA interest coverage ratio target.[11] How does that affect your recommendation?

A. The Telecom Sample's EBITDA interest coverage average increased from 7.8x to 8.4x with the removal of Sprint. As I noted in my direct testimony, UNE loop rates should reflect a level of competition somewhere between that of fully regulated monopolies and unregulated industrial companies.[12] Thus, an appropriate cost of capital for UNEs should reflect interest coverage ratios greater than former telecom benchmarks, but less than the industrial medians. Thus, the EBITDA interest coverage ratio should be bounded on the high end by the industrial median of 7.9x. My original capital structure recommendation of 4.78% short-term debt, 44.42% long-term debt, and 51.00% equity produced an EBITDA interest coverage ratio of 7.87x. Thus, I recommend no change to my original capital structure recommendation or my overall cost of capital recommendation of 8.62%.

Q. Does this conclude your direct testimony?

A. Yes, it does.

[11] ICC Staff Exhibit 12.0 at 28.
[12] ICC Staff Exhibit 12.0 at 30.